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SUBJECT: MARKETS ARE UP BUT WILL REMAIN VOLATILE

REF: MEXICO 3672

1. (SBU) Summary: Following a rough day Wednesday when the Mexican stock market dropped 4.01 percent as a result of Wall Street,s slide and temporary indications that Andres Manuel Lopez Obrador (AMLO) was ahead in the official election count, Mexican stocks and bonds have rallied today as Felipe Calderon has taken the lead and appears poised to be declared the winner by IFE. The Mexican stock market increased by 2.85 percent, and the yield on Mexico,s 10-year peso-denominated bond has declined to 8.64 percent. The peso has remained relatively stable at 11.2 pesos to the dollar. Despite today,s rally, the likelihood of a protracted legal challenge to the presidential election results will ensure continued market volatility. End summary.

2. (SBU) Following AMLO,s press conference the morning of July 6 in which he promised to contest the election results through legal means, observers predict an extended challenge that will likely last into August (Note: The electoral tribunal must resolve any hearings on complaints by August 31). Octavio Gutierrez, Bancomer,s economic analyst, expects that an AMLO legal challenge to a Calderon victory would generate continued market volatility in the coming weeks. He said the bank,s message to investors is to &wait and see8 while relying on Mexico,s strong institutions and macroeconomic fundamentals. We have heard similar perspectives from other leading business figures.

3. (SBU) Despite elections uncertainty, we have no indications at this point that investors plan to remove money from Mexico. Alejandro Gomez Strozzi, Undersecretary of Economy, said Mexico would receive USD 20 billion in foreign direct investment by the end of the year, and he has seen no movement of investor funds during the elections campaign or since the vote. Financial analysts do not expect capital flight, but rather reduced profits in the coming days. Despite recent uncertainty, country risk has also remained stable and even slightly improved.

4. (SBU) Comment: Mexico has landed in what many analysts characterized as a near worst-case scenario, in which the elections were initially too close to call and AMLO promises to contest the results. Despite this scenario, Mexico,s markets appear more stable than many would have predicted and strengthened today with indications that Calderon would win the election. Speculation is rife regarding what will happen next. Domestic and external factors, including AMLO,s next political steps, the length of his legal challenge, and reactions of the international press, will determine the

extent of market volatility.

15. (SBU) Comment continued: In the immediate term, markets are likely to remain relatively calm provided that AMLO challenges the results exclusively through legal means (Note: AMLO has called for a public assembly meeting Saturday, July 8 at 5pm at the Zocalo, Mexico City's central square). Looking further ahead, it is clear that whoever is ultimately declared president will have won by the slimmest of margins. A protracted legal dispute may well further erode the next president's mandate to govern. We will need to assess carefully potential negative implications for implementing needed economic reforms and maintaining investor confidence over the longer-term.

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